No. 14047.

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

RALPH H. EATON FOUNDATION,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for Review of Decision of the Tax Court of the United States.

REPLY BRIEF FOR THE PETITIONER.

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1. Analysis of Respondent's Argument.

Respondent seemingly has three main points: (1) that it is necessary for an organization to be organized and operated exclusively for a religious, charitable or educational purpose for exemption under I. R. C. §101(6), and that it cannot qualify for such exemption if it fulfills that purpose by engaging in commercial enterprises; (2) that I. R. C. §101(6) must be read in the light of I. R. C. §101(14) and that such a reading supports the above; and (3) that there is no majority rule to the effect that the ultimate destination of the income of an organization is more significant than its source in determining an exempt status.

The separation of these points into three arguments presupposes an independence of each from the other. Respondent, however, intimates that this might not be entirely true when he states (Br. 13, 14):

> "* * * some courts have held that a claim to exemption is to be determined entirely by the ultimate destination of the claimant's income. That is of course merely another way of saying * * * that a corporation will be treated as if it were organized and operated for the required statutory purpose if its income is to be used for such purpose. Obviously that is not what the statute says and we cannot believe that Congress meant for the first requirement [of being organized and operated 'exclusively' for the required statutory purpose] of Section 101(6) to be watered down and made meaningless in that way."

Petitioner submits that, despite Respondent's belief to the contrary, a majority of the courts considering the problem do in fact treat a corporation as organized and operated "exclusively" for the required statutory purpose where its income is destined for such purpose, regardless of the manner in which such income is acquired. Since the "ultimate destination" test is, under the applicable law, merely another way of stating the "organized" and "operated" requirements of §101(6), it becomes apparent that Respondent's first argument blends into his third. It therefore will be with that latter argument, and with Respondent's second argument, that this Reply Brief will deal.

Petitioner wishes to make clear, of course, that there are additional criteria of §101(6) which are to be met, in addition to the "organized" and "operated" requirements. Since Petitioner's opening brief dwelt at length on the manner in which Petitioner met those other criteria, no further mention thereof will be made in this brief.

2. Petitioner's Contention Is Consistent With I. R. C., §101(14).

Respondent argues that if I. R. C. §101(14) is to have any meaning, §101(6) cannot apply to so-called "feeder corporations," that is, to corporations engaged in ordinary business activities whose earnings are destined for exempt organizations. Respondent cites a number of authorities to support his argument, but most of them are of no assistance to him.

Thus, *Bear Gulch Water Co. v. Com'r,* 116 F. 2d 975 (C. A. 9th), cited by Respondent, involved a corporation organized for business purposes whose ownership was taken over by an exempt corporation. The holding of the case was that the change in ownership did not cause the taxpayer to become exempt under §101(6), and there was no discussion of §101(14). In *Gagne v. Hanover Water Works Co.,* 92 F. 2d 659 (C. A. 1st), a water company owned by an exempt corporation was held not exempt under a section similar to §101(14) on the ground that the water company operated a business and did more than merely hold title. §101(6) was not involved in the *Gagne* case and no argument was made attempting to invoke the "feeder corporation" principle. Respondent also cited *Universal Oil Products Co. v. Campbell,* 181 F. 2d 451 (C. A. 7th), cert. den. 340 U. S. 850. In that case a corporation originally organized for profit was acquired by an exempt corporation and the holding was that the taxpayer had not been "organized" for the purposes required under §101(6), an undeniably sound conclusion. The case did not discuss §101(14) at all.

The only case cited by Respondent which supports his argument that, because of the existence of §101(14), "feeder corporations" cannot be included within the scope of §101(6) is the case of *United States v. Community Services, Inc.,* 189 F. 2d 421 (C. A. 4th), cert. den. 342

U. S. 932. We frankly admit that this case supports Respondent's conclusion. However, as has already been noted in our opening brief, and as will be further mentioned herein, the *Community Services* case happens to represent a distinctly minority view in all respects.

Petitioner has been able to discover only two other leading cases which discuss the interplay of §§101(6) and 101(14). The first of these is the famous *Roche's Beach, Inc. v. Commissioner,* 96 F. 2d 776 (C. A. 2nd). In that case the court stated (p. 779):

> "Subdivision 14 relates to corporations which hold title and collect income for any tax exempt organization, and such organizations include many which are not embraced within subdivision 6. Hence, the fact that subdivision 14, as we have construed it, does not include corporations which operate a business, should not lead to the conclusion that subdivision 6, which does refer to operating corporations, includes only those which directly dispense their funds for the limited purposes there stated. No reason is apparent to us why Congress should wish to deny exemption to a corporation organized and operated exclusively to feed a charitable purpose when it undoubtedly grants it if the corporation itself administers the charity. We think the language is adequate to describe both types."

The second case squarely discussing this question is the Tax Court opinion in *C. F. Mueller Co.,* 14 T. C. 922. There the majority of the court fully discussed the relationship of §§101(6) and 101(14) and its conclusion was in line with that now advocated by Respondent. The dissenting opinion also discussed this point and stated:

> "It appears to be conceded that the *Roche's Beach* case is indistinguishable from the one now before us. The suggestion that the statutory scheme envisages exemption only under section 101(14) is not new or different from that made and discarded twelve years ago in the *Roche's Beach* case and since then in all the cases which have followed it."

It is to be recalled that the conclusion reached by the dissenting judge was supported when the case was decided on appeal (190 F. 2d 120 (C. A. 3rd)), although the Third Circuit opinion did not choose to mention the point now under discussion.

Thus, of the three cases discussing the question, two support Petitioner's position and only one supports Respondent, and that one represents in its entirety a minority view. Under this state of affairs, the best that can be said for Respondent's argument is that §101 is ambiguous in the manner in which it relates certain of its internal subsections. The authorities would appear to support the conclusion that in such a case, the ambiguity is to be resolved against taxation. (*C. F. Mueller Co. v. Com'r,* 190 F. 2d 120 (C. A. 2nd); *Helvering v. Bliss,* 293 U. S. 144, 150; *Old Colony Trust Co. v. Helvering,* 301 U. S. 379, 384.)

3. The Majority Rule Adopts the "Ultimate Destination" Test.

The statement was made in Petitioner's opening brief that a "majority of jurisdictions" considering the question have held and established the "general rule" that the destination of the income is more significant than its source in determining exemption under §101(6). Respondent flatly takes issue with Petitoner's statement, and this he does despite the language of this very Court in *Squire v. Student Book Corp.,* 191 F. 2d 1018, wherein the Court referred to the "ultimate destination" test as the "general rule," and declared:

> "Since the decision of the second circuit in *Roche's Beach, Inc. v. Commissioner,* 96 F. 2d 776, most of the circuits confronted with the problem appear to have applied the 'ultimate destination' test in determining whether the profits of a commercial enterprise are exempt under §101(6), or, to put the matter

> another way, if the only purpose of the enterprise is to devote its profits to charitable or educational ends the exemption has been usually held to attach."

Petitioner is of the view that this Court was correct in its interpretation of the cases.

Since so much of Respondent's argument is predicated upon the attempt to show that there is no majority view or "general rule" on this phase of the matter, it becomes important for us to analyze Respondent's argument in some detail.

Respondent first argues (Br. 28) that there are only four cases which appear to support the "ultimate destination" test, and Respondent cites *Roche's Beach, Inc. v. Com'r, supra; Willingham v. Home Oil Mill,* 181 F. 2d 9 (C. A. 5th), cert. den. 340 U. S. 852; *C. F. Mueller Co. v. Com'r, supra;* and *Sico Co. v. United States,* 102 Fed. Supp. 197 (C. Cls.). While the numerical significance of the cases cited may not seem large, it happens that they represent the views of the Second, Third and Fifth Circuits and also the view of the Court of Claims. These views concide with broad language of the U. S. Supreme Court in *Trinidad v. Sagroda Orden de Predicadores,* 263 U. S. 578. Moreover, Respondent omitted referring to *Commissioner v. Orton Ceramic Foundation,* 173 F. 2d 483 (C. A. 6th), wherein the Sixth Circuit joined the other jurisdictions above enumerated. In the *Orton* case, the Court stated:

> "We think that the Commissioner's contention that the taxpayer was engaged in an active, competitive business for profit and that therefore the enterprise could not be considered as exclusively one for scientific or educational purposes is answered by the opinion in *Trinidad v. Sagrada Orden de Predicadores,* 263 U. S. 578, wherein the statute was construed."

Attempting to show that the four cases which he cited did not represent the majority view, Respondent suggests

that these cases are in conflict with a number of other cases. These other cases and their obvious points of distinction with respect to the majority rule are as follows:

Bear Gulch Water Co. v. Com'r, supra: here an exempt corporation acquired all of the stock of a corporation originally organized for profit; no exempt status was found, nor was there any discussion of the rule under consideration.

Stanford University Book Store v. Helvering, 83 F. 2d 710 (C. A. D. C.): exemption was denied an association in part because its profits were distributed to private individuals; under these circumstances obviously no discussion of the rule in question was in order.

Universal Oil Products Co. v. Campbell, supra: here the Court was ready to assume for the sake of argument that "the dedication of the net earnings of a business corporation to an exempt purpose constitutes operation of the corporation for that purpose"; its decision turned upon another principle of law.

Gagne v. Hanover Waterworks Co., supra: this case was decided under §101(14) and did not discuss the "ultimate destination" rule.

The only case cited by Respondent which can be considered as truly in conflict with the cases from the Second, Third, Fifth and Sixth Circuits and from the Court of Claims is *United States v. Community Services, Inc., supra,* a fact which taxpayer readily confesses.

Respondent further contends, in support of his argument that the majority rule is not what this Court considers it to be, that the four cases are also in conflict with the cases of *Better Business Bureau v. United States,* 326 U. S. 279; *Smyth v. California State Automobile Assn.,* 175 F. 2d 752 (C. A. 9th), cert. den. 338 U. S. 905; and *Chattanooga Auto Club v. Com'r,* 182 F. 2d 551 (C. A.

6th). None of these additional cases cited by Respondent turn upon consideration of the "ultimate destination" rule, although it is interesting to note that this Court in *Squire v. Students Book Corp, supra,* cited the *Smyth* case as indicating approval of the "ultimate destination" test.

Petitioner thus submits that Respondent has produced nothing to disturb this Court's previous conclusion that the majority rule is that the destination of income is more significant than its source in the determination of an exempt status.

However, Respondent next attempts to weaken the authority of the four cases by undertaking to distinguish and set apart the *Roche's Beach* and *Home Oil Mill* decisions. For this purpose, Respondent argues (Br. 29, 30) that these decisions "resulted in large part" from the fact that the taxpayer, although a separate entity, "was intended to be and was an *operating medium* for an exempt corporation which owned all its stock." Exactly where Respondent finds authority for this "operating medium" concept is not clear, for so far as we can determine, this is the first case advancing such an argument. It is, of course, known that Respondent has argued, and petitioner concedes, that a taxpayer must be organized and operated exclusively for one or more of the statutory purposes. This new refinement to the argument is apparently that even if the taxpayer is organized and operated for business it will still be exempt if it is the "operating medium" of an exempt corporation. Such a rationale for the cases of *Roche's Beach* and *Home Oil Mill* is not only new and beyond the holding of those cases: it even appears to us to go so far as to undermine the holding of the principal case otherwise supporting Respondent's position. This case is, of course, the *Community Services* case. There, it will be recalled, the taxpayer was a non-stock membership corporation whose

charter provided that its purpose was to "receive donations of cash . . ., operate a canteen refreshment service and other business ventures for the convenience of the employees [of a certain company] . . ., and to conduct other business in order to earn profits, to the end that . . . all profits so earned . . . shall be devoted exclusively to religious, charitable, scientific, literary and/or educational purposes." The Fourth Circuit opinion upon which Respondent so heavily relies very clearly disposes of this "operating medium" concept with the following language:

> "For tax exemption purposes, the charitable nature of the distributees of its income cannot be attributed to the taxpayer . . . Otherwise a purely commercial corporation could claim the exemption, if all its stock were owned by an exempt corporation, which would receive, as dividends, all the net earnings of the commercial corporation. Clearly this is not the law."

The conclusion which the Fourth Circuit reached would, of course, have been exactly the opposite were the "operating medium" concept of Respondent adopted.

Petitioner, of course, submits that the *Community Services* case was decided incorrectly, but the point of this discussion is that the incorrectness does not stem from a misapplication of the "operating medium" concept contended for by Respondent, but rather from a refusal to recognize the majority view regarding the "ultimate destination" test.

Respondent, in his brief, even shows dissatisfaction with the authority of the two remaining cases with which Respondent admits himself to be still saddled. These cases are, of course, the *Mueller* case and the *Sico Co.* case. (It will be remembered that Respondent has not even referred to the *Orton Ceramic* case, *supra.*) These two cases Respondent considers to have been erroneously decided be-

cause in neither was the organization involved an "operating medium" of an exempt organization. Respondent contends that therefore there was no basis for attributing "functional charitable activities" to the organizations involved and, Respondent further argues, "a functional charitable activity is a condition to exemption under Section 101(6)" (Br. 31).

Petitioner submits that again Respondent has chosen to clothe the issues in this case with new and totally undefined language. Petitioner is at a loss to know the meaning of the term "functional charitable activity." From the context of Respondent's brief, it is gathered that this term is intended to apply only to organizations which are engaged in running a hospital or conducting school classes or other similar pursuits, and to exclude organizations which merely give money to other charitable organizations. If this is *not* what Respondent intends by the term, then Petitioner is at a loss to countervail Respondent's arguments. If, on the other hand, this conjecture as to Respondent's intention is accurate, then it is submitted that what Respondent is *really* arguing is that "feeder corporations" are not covered by §101(6). This argument is, of course, the classic one with which many of the cases herein discussed have concerned themselves. The issue under it is then reduced back to whether the majority view of the "ultimate destination" test is to be adopted, and excursions into uncharted semantic areas are thus avoided.

If this kind of approach is not adopted, one must then reckon with the additionally strange contention of Respondent (Br. 31, 32) that the cases cited by the *Mueller* case on appeal are to be explained on the ground that the commercial activity was only "incidental" or "related and necessary" to the charitable activity. It is submitted that there is something wrong with explanations of this type

when referred to such cases as *Debs Memorial Radio Fund v. Com'r,* 148 F. 2d 948 (C. A. 2nd), wherein the taxpayer operated a radio station, or to *Commissioner v. Orton Ceramic Foundation, supra,* wherein the taxpayer manufactured ceramic cones.

It is therefore Petitioner's conclusion that Respondent has taken a legal issue, namely, the "ultimate destination" test, with respect to which there is no dearth of authority, and, instead of facing the issue squarely, has attempted to distinguish the majority rule on the basis of concepts such as an "operating medium" or a "functional charitable activity"—concepts which the courts do not discuss and Respondent does not define.

It might be noted on this point that Respondent takes some solace for his position from the passage of Section 301 of the 1950 Revenue Act. By that Act, it will be recalled, "feeder corporations" are taxed on their unrelated business net income. Respondent states that these legislative provisions were merely a clarification of the existing law and did not change it, citing the *Community Services* case. While it is true that the *Community Services* case so held, this Court stated in *Squire v. Students Book Corp.* that the 1950 Revenue Act provisions "declared a *different rule* applicable for taxable years commencing December 31, 1950" [italics supplied].

It would finally appear that Respondent's arguments are more addressed to what he believes the law *ought* to be rather than to what, under the "historical approach" of the *Mueller* case on appeal, the law in fact was during the taxable years in question. Petitioner's position is that where an organization is created and operated in such a manner as to exclude private gain, the "ultimate destination" test has been applied by most jurisdictions considering the problem and represents the sound view of the law prior to the 1950 Revenue Act.

4. Petitioner Was Exempt Under I. R. C. § 101(6).

The Tax Court decision in the instant case was squarely grounded upon the rejection of the "feeder corporation" theory of exemption. This was a narrow, and it is submitted erroneous, ground of decision.

Should this Court decide to align itself with the Second, Third, Fifth and Sixth Circuits and with the Court of Claims, and determine to reject the view of the Tax Court and the Fourth Circuit, it will further be necessary for this Court to find as a matter of law—or for this Court to remand to the Tax Court for its further factual finding—that Petitioner in the instant case fits within the majority rule, and within the other requirement of §101(6). Our opening brief attempted to provide the arguments supporting such a finding that Petitioner meets all the tests of exemption laid down by I. R. C., §101(6).

Conclusion.

Petitioner respectfully submits that the Tax Court decision is in error and should be reversed.

Respectfully submitted,

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Attorney for Petitioner.

Dated: March 1, 1954.